No. 16092

United States
COURT OF APPEALS
for the Ninth Circuit

STEVEN VOLOUDAKIS and KATHERINE VOLOUDAKIS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPELLANTS' OPENING BRIEF

Petition to Review a Decision of the Tax Court of the United States.

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JURISDICTION

This appeal involving a redetermination of deficiencies in income taxes, and penalties for the years 1949, 1950, 1951, 1952 and 1953 is taken from the decision of the Tax Court of the United States entered on the 18th day of March, 1958 (R. 39), pursuant to Findings of Fact and Opinions filed in said court on the 12th day of March, 1958 (R. 23). The Tax Court had jurisdiction under the provisions of the laws of the United States, particularly 26 U.S.C.A. 7442 (I.R.C. 1954), 26 U.S.C.A. 6212, 6213, 6214 (I.R.C. 1954).

Petitions for review were filed by petitioners on June 11, 1958 (R. 40). Accordingly, this Court has jurisdiction under the laws of the United States, particularly 26 U.S.C.A. 7482, 7483 (I.R.C. 1954).

STATEMENT OF THE CASE

The parties involved in the transactions with which this case is concerned are Steven and Katherine Voloudakis, original lessees, herein referred to as "Appellants," the Sweeny Investment Company of Spokane, Washington, owners of the subject property and lessor, herein referred to as "Sweeny," and the Pacific Telephone and Telegraph Company, the ultimate lessee, herein referred to as "Pacific."

The question here presented for decision is whether the proceeds received by Appellants from a transaction whereby a leasehold estate which they had acquired was transferred to Pacific, were entitled to be taxed on a capital gains basis as the proceeds of a "sale or exchange," or whether they were taxable as ordinary income as rental under a sublease.

STATUTES INVOLVED

Capital Gains:

I.R.C. (1939) 117 (a), 117 (4).

Ordinary Income:

I.R.C. (1939) 22 (a).

Penalties:

I.R.C. 291 (a).
I.R.C. 294 (d) (1) (A).
I.R.C. 294 (d) (1) (B).
I.R.C. 294 (d) (2).

THE FACTS

As their name indicates, the Appellants were Greek immigrants, who have been engaged in the cleaning and second-hand clothing business in the City of Portland (R. 19). Sweeny was the owner of an entire block situated in the City of Portland, Oregon, between the streets of S.W. 13th, S.W. 14th, Morrison and Alder, on which there was a one-story building covering the entire block (R. 20). Prior to March 5, 1946, Appellants had been carrying on their business in a portion of this building. Other parts of the building had been leased to other tenants. On March 5, 1946, Appellants entered into a lease agreement with Sweeny for the entire block, subject to the other tenancies which were shortly to expire (R. 45). As additional space became available Appellants expanded their business operation, remodelled the building to suit their needs and purchased a substantial amount of equipment (R. 46).

For some time prior to April 8, 1947, Mr. Churchill Cook, a realtor of Portland, as agent for Pacific, had been endeavoring to locate additional space for that company to accommodate its expanding operation (R. 57). Pacific was under the immediate necessity of moving its revenue accounting office and was looking for some 50,000 square feet of office space, or five contigu-

ous floors in an office building (R. 58). Mr. Cook had been unsuccessful in locating any such space for Pacific until he learned that Appellants had a lease on the entire Sweeny block, so, as he said, "I walked in and introduced myself to him (Appellant), and asked him (Appellant) whether he would consider selling out and getting out" (R. 58). After some negotiations Appellants agreed to vacate the premises completely to Pacific (Exs. N and O) for the balance of their lease term, and which negotiations ultimately culminated in the execution of a three-way agreement between Sweeny, Pacific and Appellants (Ex. 2-B) (R. 58). This new three-party agreement covered all and precisely the same property covered in the original lease to Appellants; it ran for the full balance of the term of the former lease and on almost precisely the same terms, except as to the rental reserved.

Under the 1947 agreement Pacific was obligated to pay rent directly to Sweeny (Ex. 2-B, Par. 2(a)), and Pacific covenanted with Sweeny to carry out the usual obligations of a lessee (Ex. 2-B).

Appellants had no further obligation to Sweeny under the 1947 agreement, either to pay rent or otherwise (Ex. 2-B; R. 47, 48).

As a consideration for this agreement Pacific agreed to pay Sweeny $1,900.00 per month rental. (This included the $1,600.00 per month rental due from Appellants to Sweeny under the original lease and a $300.00 a month increase.) Pacific also agreed to pay Appellants $35,-000.00 upon the execution of the agreement, and addi-

tional monthly payments throughout the entire balance of the lease period of approximately nine years (Ex. 2-B).

Subsequent to the execution of the lease to Pacific Appellants vacated the premises completely. "I just put my coat on, cleared up the place, and that's the last I've seen of it." (R. 48).

The Appellants intended to transfer, and Pacific intended to obtain, all of the leasehold premises for the full remaining period of Appellants' term (Ex. N, Ex. 2-B; R. 49, 50).

Pacific immediately took possession and "did very extensive remodelling because it virtually was a, oh, garage-type structure, what there was, and they spent a large sum of money to make it into office space," and, indeed, rendered the property unsuitable for any occupancy but their own (R. 59). Pacific remained in occupancy during the entire balance of the lease.

When Pacific's right to possession of the premises expired under the agreement of April 8, 1947, Appellants made no claim to possession, nor were they contacted in any way by either Sweeny or Pacific (R. 49). Upon its expiration Pacific remained in possession under a new lease with Sweeny.

Appellants had no further business transactions in connection with the property or with Sweeny or with Pacific, except the receipt of monthly payments from Pacific provided for in the agreement (R. 48).

In the first income tax return filed by Appellants subsequent to the Pacific lease, the transaction of April 8,

1947 was accurately reported on the return and capital gains treatment of the payments received was claimed on the grounds that the transaction constituted a sale of a capital asset, to-wit: Appellants' leasehold interest in the property (R. 20). No question was raised as to this procedure for several years thereafter, and Petitioners continued to file their tax returns in each case containing a statement of the transaction and giving the receipts of the transaction capital gains treatment and paying the tax thereon.

Not until February 21, 1956 (R. 7), was any question raised, when the Respondent took the position the transaction above referred to was not a sale of Appellants' leasehold interest, and entitled to capital gains treatment, but was a sublease to Pacific and that the payments received were rental income and therefore taxable as ordinary income to Appellants. Their tax liability was recomputed on this basis and a deficiency assessment levied against them as follows:

		Additions to tax			
ar	Deficiency	Sec. 291(a)	Sec. 294(d)(1)(A)	Sec. 294(d)(1)(B)	Sec. 294(d)(2)
19	$1,868.66	$ 467.16	$ ..	$ 4.00	$145.95
50	3,241.66	..	387.47	..	258.31
51	3,635.80	..	..	52.50	261.78
52	4,093.68	1,023.44	..	75.00	254.63
53	5,899.84	..	..	97.50	397.64

A timely petition for review of the Commissioner's assessments was filed by Appellants (R. 3), a hearing was held before the Tax Court of the United States (Withey, Judge) in February, 1957. The Court's opinion was filed March 12, 1958 (R.23-39) and the decision was

entered March 18, 1958, sustaining the assessment of the Commissioner and holding the amounts received by Petitioners during the years in issue from Pacific pursuant to the terms of the agreement executed April 8, 1947 constituted rental income, taxable under Section 22 (a) I.R.C. 1939 (R. 39, 40). The decision also affirmed the assessment of the penalties listed in the above schedule. With reference to these penalties, Mr. Picco, counsel for the Respondent in the hearing before the Tax Court, made the following statement:

> "I may say one other thing, your Honor. It appears there are some delinquency penalties and negligible penalties also involved in this case but I do not think Petitioners are contesting those particular penalties, so far as the merits are concerned."
>
> "Of course, if they win on a primary issue that will take care of itself."

The gist of the decision below is as follows:

> "The petitioners insist that, under the applicable principles of the law of real property prevailing in Oregon, the transaction in question resulted in an assignment of the lease by petitioners to Pacific, rather than a sublease, with the result that petitioners disposed of the remainders of the leasehold term, retained no rights or obligations under the original lease and 'stepped out of the picture.' However, petitioner points to no Oregon statute or decision, and we find none, which would alter the application of common law principles to the issue presented. At common law, an assigning lessee does not remain liable to his landlord for rent or for the performance of any of the covenants of the lease. *Moline v. Portland Brewing Co.*, 73 Ore. 532, 144 P. 572, 1 *Tiffany, Real Property,* sec. 124 (3d ed. 1939); 32 Am. Jur., Landlord and Tenant, Secs. 313, 314, 318; I American Law of Property, p. 310. Under a sublease, however, the lessee does not dis-

pose of his entire term under the lease and remains liable to his landlord for the payment of rent and for the performance of the other covenants of lease, unless specifically released therefrom. See *Tiffany op. cit. supra,* p. 202. Here, we find nothing in the agreement of April 8, 1947, which either specifically or by implication indicates an intent on the part of Sweeny to release or discharge petitioners from their liabilities as tenants under the original lease.

"Since the parties to the agreement in controversy did not eliminate the petitioners and substitute Sweeny (sic) in their place, the normal incident of an assignment of lease did not occur. See Tiffany, *op. Cit. supra,* p. 197; I American Law of Property, p. 310. Petitioners also retained under the agreement a right of re-entry and the ousting of Pacific for condition broken. If a complete assignment had resulted from the execution of the foregoing agreement, petitioners would have retained no interest in the premises but instead would have been relegated to their contractual remedies in the event of a breach. The original lease agreement executed by petitioners and Sweeny on March 5, 1946, was not canceled but continued in force, and petitioners remained liable thereunder. We are of the opinion that the transaction consummated on April 8, 1947, was a sublease, rather than an assignment, and we accordingly hold that the amounts received by petitioners from Pacific during the years in issue constitute rental income taxable under Section 22 (a) of the 1939 Code." (R. 36-38)

SPECIFICATIONS OF ERROR

1. The Tax Court was in error in its opinion and decision that the transaction consummated on April 8, 1947 (Ex. 2-B), was a sublease rather than an assignment of Appellants' leasehold estate, and accordingly, that the

amounts received by Appellants from Pacific during the years in issue constitute rental income taxable under Section 22 (a) of the 1939 Code, and not capital gains; that such opinion and decision are not supported by the facts, are contrary to the facts and contrary to applicable law.

2. The Tax Court was in error in affirming the Commissioner's assessment of penalties for the tax years in question under both Section 294 (d) (1) and Section 294 (d) (2) of the Internal Revenue Code.

SUMMARY OF ARGUMENT

It will be the contention of Appellants that the transaction consummated on April 8, 1947, and evidenced by Exhibit 2-B, constituted as between Appellants and Pacific, a sale or assignment of Appellants' leasehold estate in real property, a capital asset; that the payments received by Appellants from Pacific were installment payments on the purchase price and as such were properly reported by Appellants on a capital gains basis and taxable accordingly; that the transaction as between Appellants and Pacific was *not* a sublease and the payments received from Pacific were *not* rental payments and taxable as ordinary income under Section 22 (a) I.R.C. 1939.

As between Sweeny and Pacific the transaction was clearly and definitely a lease as the contract is labeled. Appellants were made parties to the agreement to effect a transfer or assignment of their leasehold interest.

The decision in this case hinges on the determination of whether or not the document executed April 8, 1947, by Pacific and Sweeny (Ex. 2-B) constituted, in legal effect, an assignment of Appellants' leasehold interest in the premises to Pacific as contended by Appellants, or whether it was a sublease of their leasehold estate, or a part thereof to Pacific, as held by the Tax Court.

It is the contention of Appellants that the undisputed facts do not support the findings and conclusions of the Tax Court; that the Tax Court was in error in its statement of the legal propositions cited in support of its decision; and that the decisions and authorities cited do not support those propositions.

Contrary to the suggestion of the Tax Court, Appellants do not contend that there is any Oregon decision "which would alter the application of common law principles to the issue presented." On the contrary, Appellants argue for the application of well-established common law principles and principles which have been approved in repeated decisions by the Oregon Supreme Court. It is not the law in Oregon, or generally, that "an assigning lessee does not remain liable to his landlord for rent or for the performance of any of the covenants of the lease." The *Moline* case (73 Ore. 532) cited by the Tax Court in support of this proposition was not followed in the later case of *Houston v. Barnett,* 90 Ore. 94, and was expressly repudiated in *Barde v. Portland News Publishing Co.,* 152 Ore. 77 (p. 82). Neither do the citations from 32 Am. Jur. nor from Tiffany on Real Property support this asserted proposition.

The Tax Court found that the new contract (Ex. 2-B "did not eliminate the petitioners and substitute Sweeny (sic) in their place." This new agreement clearly was a direct and complete substitute for the original lease of March, 1946, by which the owner, Sweeny, leased to Pacific the identical property for the precise period of time and under practically identical conditions and terms specified in the original lease. Pacific became a direct lessee in possession under Sweeny replacing appellants.

The Tax Court considered the provision for a right of reentry on condition broken as significant, if not controlling, in determining that the document was a sublease and not an assignment. The great weight of authority, however, is that such a provision does not alter the nature of the agreement; that such provision merely provides a chose in action and not a reversionary interest.

The lower court also held that the original lease of March 5, 1946, "was not cancelled but continued in force," and this in spite of the fact that the owner had leased this property, all of it, for the full balance of the term to Pacific, in which lease the Appellants joined in order to dispose of their interest.

Based upon these misconceptions of the rules of law applicable and the misapplication of the authorities cited, the Tax Court arrived at the conclusion that "we are of the opinion that the transaction consummated on April 8, 1947 (Ex. B) was a sublease rather than an assignment, and we accordingly hold that the amounts received by Appellants from Pacific during the years in

issue constituted rental income taxable under Section 22 (a) of the 1939 Code," regardless of the fact that the legal consequences of the transaction effected a complete transfer to Pacific of Appellants' entire leasehold estate.

It will also be contended by Appellants that the Commissioner should not have assessed penalties for the same years for substantial understatement of estimated tax and, in addition, a penalty for failure to file declaration of estimated tax, and particularly that it was improper for him to assess a penalty for substantial understatement of estimated tax when the error was not an understatement or an underestimation, but an error made in good faith as to the basis of the tax (Stip. Facts 5, 6; R. 20, 21).

ARGUMENT

At the outset it may appropriately be pointed out that it has never been contended in this proceeding that the assignment of a leasehold does not qualify for capital gains treatment under Section 117 (J), Internal Revenue Code 1939. The issue here is whether the transaction of April 8, 1947 constituted an assignment of Appellants' leasehold estate, as they contend, or was a sublease thereof as held by the court below.

In asserting the proposition that "an assigning lessee does not remain liable to his landlord * * *" the decision below first cites and underscores the Oregon case of *Moline v. Portland Brewing Co.*, 73 Ore. 532. However, in the later Oregon case of *Houston v. Barnett*, 90 Ore.

94, the Oregon Supreme Court held to the contrary (p. 100):

> "Notwithstanding the assignment, Barnett as lessee continued liable on the covenants in the lease to pay rent and taxes which accrued subsequent to the assignment. After the transfer the assignee then became liable to the lessors for the rental and taxes, and the lessors at their election could then sue either the lessee or the assignee, or both at the same time, although they could have but one satisfaction. It is well-settled that the assignee of a leasehold is personally liable for rent accruing while he retains the leasehold."

Both the *Moline* case and the *Houston* case were referred to in the decision of the Oregon Supreme Court in the case of *Barde v. Portland News Publishing Company,* 152 Ore. 77, wherein the Court (at p. 82) after quoting from the *Houston* case the portion set forth above, said:

> "We are not unmindful that the ruling in *Moline v. Portland Brewing Co.* * * * which announced a contrary doctrine to that announced in *Houston vs. Barnett,* supra. The rule announced in the *Moline* case is not supported by any authority cited therein and is shown to be incorrect by all the authorities bearing upon the question in the absence of some covenant or agreement on the part of the assignee to perform the terms and conditions contained in the lease which, of course, would render an assignee liable for rent during the entire term whether in the meantime he had reassigned the lease or not."

Thus the Tax Court's authority was repudiated.

The Tax Court decision further cites 32 Am. Jur., Landlord and Tenant. We quote the following from this authority:

"An assignment of a leasehold is a transaction whereby a lessee transfers his entire interest in demised premises, or a part thereof, for the unexpired term of the original lease, thereby parting with all of the reversionary estate in the property, and is thus distinguishable from a sublease which contemplates the retention of a reversion by the lessee. The form of the transaction is not material, its character in law being determined by its legal effect. In the case of a written transaction, this is a question of law to be determined from the estate granted in the instrument executed. A transaction between a lessee and a third person in the form of a lease or sublease may nevertheless operate as an assignment as between the original lessor and such third person. (Sec. 313, p. 289)

"The distinction between an assignment of a lease and the subletting of the premises lies in the quantity of interest that passes by the transfer, and not upon the extent of the premises involved. Primarily, the test is whether, by the transaction, the lessee conveys his entire term or retains a reversionary interest, however, small. As a general proposition, if by the transaction the lessee conveys the entire term and thereby parts with all reversionary interest in the property, the transaction is construed to be an assignment; but if there remains a reversionary interest in the estate conveyed, it is a sublease. * * * The tenant who parts with the entire term embraced in his lease becomes an assignor of the lease, and the instrument is an assignment; but where the tenant, by the terms, conditions or limitations in the instrument does not part with the entire term granted him by his landlord so that there remains in him a reversionary interest, the transaction is a subletting, and not an assignment. * * * And at common law, a leasing by the lessee for the entire term, even at a different rent, reserving the right of re-entry for condition broken, as between landlord and the sublessee, was regarded as an assignment of the term. However * * * the

instrument must convey not only the entire time for which the lease runs, but the entire estate or interest conveyed by the lease." (Par. 314, pp. 290, 291)

"Some of the authorities take the view that a provision for the redelivery of the possession to the original lessee on the last day of the term renders the transaction a sublease and not an assignment, but others hold that if the transaction is in the form of lease for the entire period of the unexpired term of the original lease, it is to be regarded as an assignment and not a sublease, even though the instrument contains a provision for the surrender or redelivery of the possession to the original lessee at the end of the term." (Par. 316, p. 292)

(Note: Paragraph 18 of the Pacific contract, Ex. 2B, DOES NOT provide for redelivery of possession to Appellants, the original lessees.)

"While it is generally agreed that a reservation of rent in an instrument in the form of a lease will not change the legal operation of the instrument as an assignment if the lessee parts with his entire interest in the term, there is considerable conflict of authority as to whether the reservation of a right of re-entry for the assignee's breach of covenant and conditions necessarily stamps the transaction as a sublease rather than an assignment. The generally accepted view, however, is that the reservation of such a power of re-entry is not sufficient to prevent the transaction from being an assignment. This rule is based on the theory that the right of re-entry is not an estate or interest in land nor the reservation of a reversion; but is merely a chose in action, and, when exercised, the grantor comes into possession of the premises through the breach of the condition and not by reverter." (Par. 317, p. 292)

The Tax Court in its decision herein seems to rely

heavily on the authority of Tiffany on Real Property. From the various sections cited in its opinion we quote the following:

> "A transfer of the tenant's entire interest in the whole premises leaving no reversion to him has usually been regarded not as a sublease but as an assignment * * *. And the fact that the transfer is in the form of a sublease or reserves rights as against the transferee similar to such as are ordinarily reserved on a lease, has been considered immaterial * * *." (Sec. 123, p. 97, 1 Tiffany on Real Property, 3rd ed. 1939)

> "The sublessee is not privity of contract with the head landlord since there is no contractual relation between them." (Sec. 124, p. 201, ibid)

> "As a lessee is not relieved of his contractual liabilities by his assignment to another even though the other becomes liable," etc.

> "The lessee is, however, relieved from liability if the sublessee is substituted as tenant by a new demise effectuating a surrender of a former term." (Sec. 124, p. 202, ibid)

There can be no doubt but that the propositions enunciated in the foregoing authorities are the established law in Oregon under decisions of the Oregon Supreme Court.

> " 'Where a person other than the lessee is shown to be in possession of leased premises, paying rent therefor, the law will presume that the lease has been assigned to him.' " *First National Bank v. Hazelwood Co.,* 85 Ore. 403, 407.

> "A distinction properly may be drawn between a case of subtenancy and one where the original tenant assigns to another the whole of his estate under the lease. The owner of the fee may create an estate for years in the land by a lease to his tenant, re-

serving a rent. The tenant, being thus the owner of an estate in land, may of right, unless restrained by the terms of the lease, convey that estate entirely to another, who thus becomes the assignee of the lease, assuming all its obligations, including the payment of the rent. By virtue of the transfer of this entire identical estate originally created by the owner of the fee, there springs up by operation of law a privity of estate between the original landlord and the subtenant, that is to say, they are both concerned in the same estate, the one as its creator and the other as its assignee. This is not true, however, where the original tenant creates a new and different estate, although one for years, and confers it as a lessor upon a subtenant. No privity of estate arises under such circumstances, between the owner in fee and the subtenant. It is not an estate to the creation of which the owner in fee has been a party. The contract by which the subtenancy was created was a transaction to which he was a stranger and in which he cannot be compelled by a subtenant to participate." *Backus v. West et al,* 104 Ore. 129 141, 142)

In an earlier case the Oregon Supreme Court said:

"Tiffany on Landlord and Tenant (page 950) states that, for the purpose of enforcing the payment of rent, a person, other than the lessee, found in possession of the premises will be prima facie presumed to be in possession as signee of the leasehold, which presumption may be rebutted by evidence that there was no actual assignment, or that he is a sublessee, in which latter case he is not liable to the landlord on the covenants of the original lease. His liability is upon the covenants of the sublease and to his lessor only." *Culver v. Van Valkenburgh,* 60 Ore. 447, 449.

Thus the basic distinction between an assignment of a lease and a subletting is clearly recognized by the Supreme Court of Oregon. Furthermore, while there is

no case squarely on the point, the Oregon Supreme Court, consistent with its decisions, could not do otherwise than follow the general rule announced in Am. Jur., supra, that the legal consequences of the document being an assignment would not be affected by its being couched in the terms of a lease, or was called a lease, and used such other terms as "lessor," "lessee" and "rent."

> "If the instrument styles itself a lease and employs words commonly found in leases, like lessor, lessee, etc., we have circumstances which indicate that the authors intended to create the relationship of landlord and tenant, but these circumstances are not controlling. (Tiffany, Landlord and Tenant, § 7, footnote 119). The courts construe the whole mass of words and not merely some of them."

(In this case the Court held the document denominated a lease to be only a license.) *Strandholm v. Barbey,* 145 Ore. 427 (441).

> "In construing a written lease, the intent must be gathered from an examination of the whole instrument, and such a construction should be given it, if possible, as will render all its clauses harmonious, so as to carry into effect the actual purpose and intention of the parties as derived therefrom. To give such an instrument a narrow and technical interpretation is contrary to well-settled rules of construction." *Dellwo v. Edwards,* 73 Ore. 316, 323.

The foregoing was quoted with approval in the later case of *Buck v. Mueller,* 207 Ore. 169 (p. 173).

Applying the tests approved by the foregoing authorities to the contract of April 8, 1947 (Ex. 2-B), the conclusion is inescapable that an assignment was made by the Appellants of their leasehold estate to Pacific.

The first and principal test is whether or not the lessee has transferred his interest in the property for the entire period of his lease. (Exhibit 2-B covers precisely the same property covered by the original lease and for precisely the same period of time, both of them terminating on the same date by their specific provisions.) Probably the second most significant test is whether or not there was any reversion reserved to the original lessee. In this case there was not (Ex. 2-B, § 18). Another test suggested is the extent of the obligation assumed by the assignee. In the instant case the two documents are almost identical, paragraph by paragraph, condition by condition, which Pacific covenants directly with Sweeny to perform. Appellants are placed under no obligation to Sweeny. In this connection it is especially significant that the later contract (Ex. 2-B) provides that Pacific shall pay all of the rent to Sweeny instead of to Appellants as sublessors. This rental in the amount of $1,900.00 per month replaced the rent reserved under the previous lease payable by Appellants ($1,600.00 per month) to Sweeny. In these circumstances Pacific had no way of escaping full liability, either by abandoning the leased property or re-assigning. (*Barde v. Portland News Co.*, 152 Ore. 77, 82.)

When Sweeny, the owner of the fee, executed the new contract of April 8, 1947, leasing to Pacific the identical property covered by the earlier lease, for the identical period, under identical conditions, all of which the new lessee agreed to assume, including the payment of the original rental reserved under the initial lease, that initial lease was abrogated or absorbed (Tiffany,

Real Property, Sec. 124, p. 202, quoted supra). When Appellants joined in the execution of that document their interest passed completely to Pacific and became merged with the new leasehold estate. There can not be two subsisting leases to different persons on the same property, for the exact period of time, and under the same conditions. Furthermore, under the later document the Appellants were eliminated from any obligation or requirement. They were no longer obligated to pay any rent to the landlord nor perform any other duty. All they had to do was to receive from Pacific the payment to them of the monthly installments. After the execution of this later document Appellants retained absolutely nothing except a claim on Pacific for the payment of their monthly installments, installments on the purchase price for the assignment.

Appellants joined in the new lease of the property from Sweeny to Pacific in order to dispose of their leasehold estate. A parallel situation occurred in the case of *Walter H. Sutliff v. C.I.R.,* 46 B.T.A. 446, where a lessee joined in a deed from his landlord conveying the leased premises to a purchaser. Referring in its decision herein to the *Sutliff* case, the Tax Court said (R. 33):

> "In Walter H. Sutliff, supra, the taxpayer as lessee joined with the owner in fee of the premises in a deed conveying the property to a purchaser. We there rejected the contention of the Commissioner that a portion of the consideration received by the taxpayer was a substitute for the rental payments which he might receive throughout the unexpired term of his lease, and held that he had disposed of his leasehold interest in the property and was entitled to report the proceeds as capital gain."

We have emphasized, perhaps over-emphasized, the Oregon decisions which establish clearly and firmly the propositions of law upon which Appellants' contentions are based, principally because the decision in the court below cited a repudiated Oregon decision as authority for a rule which does not prevail in Oregon as the basis for its erroneous decision. The Tax Court in its opinion pointed out Appellants' default in citing Oregon decisions in support of their contentions. It seemed advisable not to repeat this error.

FEDERAL AUTHORITIES

The decisions of the Federal Courts, both District and Appellate, seem clearly to establish the following propositions which support Appellants' contention and which are summarized below:

The proceeds from the sale or assignment of a leasehold estate are taxable as capital gains. *C.I.R. v. Ray,* 210 F.2d 390.

Also, payments for "vacating and surrendering the premises" (which was in fact accomplished here) have been held entitled to capital gains treatment on the theory that the transaction resulted in an assignment or sale. *C.I.R. v. Golonsky,* 200 F.2d 72; *C.I.R. v. McCue Bros.,* 210 F.2d 752. Indeed, the Tax Court itself has generally recognized this underlying principle. *Brecher v. C.I.R.,* 16 T.C. 469; *Ruwitch v. C.I.R.,* 22 T.C. 1053, and *Sutliff v. C.I.R.,* 46 B.T.A. 446 (1942).

In determining whether there has been a sale or an assignment of a leasehold estate, the designation of the

instrument or the language used therein is not conclusive of its true nature, but the Court will "consider the intent of the parties and the legal affect of the instrument as written." *Oesterreich v. C.I.R.,* 226 F.2d 798; *Benton et ux v. C.I.R.,* 197 F.2d 745; *Converse v. Earle,* U.S. Dist. Ct. of Oregon, Civ. No. 5778 (Aug. 9, 1951).

Neither is it material that the assignor was to receive the consideration in monthly or other periodic installments, or payments. *Brecher v. C.I.R.,* supra; *Jones v. U. S.,* 96 F. Supp. 973; *U. S. v. Jones,* 194 F.2d 783.

Landlord executing a new lease automatically releases the old lease and the original lessee, except as to such rights as are specifically reserved. *Jones v. Winchester,* 61 F.2d 774 (775).

> " * * * If one other than the lessee is in possession of premises, paying rent, the law will presume that the lease of the property has been assigned to such person." *Northwestern Co. v. Security Co.,* 261 F. 575 (578).

(The foregoing is from a decision by this Court upon an appeal from a decision of the District Court of the United States for the District of Oregon.)

Great significance was attached to the use of the terms "lease," "lessor," "lessee," "rent," etc. by the trial judge, although neither the Commissioner nor the Tax Court adhere consistently to the erroneous proposition that the labels on a document control and determine its character, or that the use of terminology is decisive.

In the case of *H. T. Benton et ux v. C.I.R.,* 197 F.2d 745, the Commissioner and the Tax Court vigorously

contended that a "lease" with option to purchase executed by the taxpayer was, in fact, a contract of purchase, and that the rental payments provided for in the lease were not deductible as business expense. The Tax Court's decision sustained the Commissioner, on the so-called "economic theory" where the record showed the down payment provided for in the agreement was large enough, over and above normal depreciation, to give the purchaser an equity in the property. The Circuit Court of Appeals did not disapprove of this theory, but held that it had been misapplied to the facts. It said in part (p. 752):

> "For the Commissioner and the Tax Court to decide solely by the application of an objective economic test that the taxpayer had an equity in the property, effectively begs the question to be decided, namely whether what was in form a lease was in substance and according to the real intention of the parties a conditional sale contract."

The Court of Appeals emphasized the necessity to make a realistic determination of the true nature of the agreement and the intent of the parties, and reversed the Tax Court decision.

In the United States District Court for the District of Oregon the Commissioner contended that the sale of logging machinery pursuant to a sales contract was not, in fact, a sale, and that the proceeds received therefrom was ordinary income and taxable as such.

> *Converse v. Hugh H. Earle, Collector of Internal Revenue,* Civ. No. 5778, Aug. 9, 1951.

In a carefully reasoned decision in the United States District Court for the Western District of Virginia

(*Lemon v. U. S.*, 115 F. Supp. 573) the Court had before it a document denominated "lease and option," which provided for the rental of an airplane for a period of six months for $14,000.00, with the option to purchase the airplane at the end of the period for an additional $14,000.00. The Court nevertheless held the transaction to be a sale and the Court said in part (p. 576):

> "The contract which gives rise to the controversy here is designated a 'Lease and Option' and its language bears out its title. But it is well-settled that the designation given the transaction is not conclusive of its true nature." (Citing authorities)

In the *Oesterreich* case referred to above, this Court of Appeals for the Ninth Circuit, made the following statement upon the proposition which lies at the basis of Appellants' contentions:

> "There is only one issue presented in this case. Is petitioner entitled to treat 'rental' payments made by 'lessee' as long term capital gains or must she treat them as ordinary income? * * * *The courts, in making a determination of this sort, commonly consider the intent of the parties and the legal effect of the instrument as written.* * * * It seems well established that calling a transaction a 'lease' does not make it such, if in fact it is something else. To determine what it is, the Courts will look to see what the parties intended it to be. Both petitioners and Wilshire Holding Corp. have at all times referred to the agreement as a lease and they have treated the payments as rental income and rental expense, respectively. For this reason, perhaps, the tax court assumed that the parties intended a lease. However, the test should not be what the parties call the transaction nor even what they mistakenly believe to be the name of such transaction. What the parties believe the legal effect of such transaction to be should be the criterion. If the parties

> entered into a transaction which they honestly believed to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease, no matter what they call it or how they treat it on their books. *We must look, therefore, to the intent of the parties in terms of what they intended to happen.*" (Emphasis supplied) (226 F.2d 798, p. 801)

The circumstance that Appellants were to receive payment of their part of the consideration in monthly installments during the balance of the original term of their first lease, would not affect the character of the transaction or disqualify it from capital gains treatment.

In the case of *Jones et al v. United States,* 96 F. Supp. 973, the Court had before it a situation in which plaintiff claimed capital gains treatment on his share of the net income from a franchise which had been assigned to his partner upon the dissolution of the partnership. These payments were made periodically throughout the entire balance of the franchise term. The District Court of Colorado rejected the Government's contention that the plaintiff had retained an interest in this asset, and that therefore the income he received was ordinary income and taxable as such. It entered judgment in favor of plaintiff for the refund due on the basis that these payments represented the consideration received by plaintiffs from the sale of an asset and were therefore entitled to capital gains treatment.

The United States Court of Appeals for the Tenth Circuit (*United States v. Jones, et al,* 194 F.2d 783) on review affirmed the District Court. The Court said (p. 785):

> "The Collector contends that by the clear and unambiguous terms of the dissolution agreement Andy (Jones) retained his interest in the bus franchise and the Taylor lease until its expiration in 1946. * * * The trial court found that by the terms of the dissolution agreement the parties intended that Durwood should become the absolute owner of the bus franchise * * * and concluded that the amounts received by Andy (Jones) during the taxable years in question were part of the purchase price provided for in the agreement and should be taxed as capital gains during the years which the payments were received. We conclude that the finding of the trial court that the transfer of the bus franchise constituted the sale of a capital asset is sustained by substantial evidence and that the judgment of the trial court is not clearly erroneous. (Authorities) * * *
>
> "The judgment is affirmed."

The real intention of the parties here seems just as clear and positive as the foregoing applicable rules of law: Pacific desperately needed and bought outright Appellants' entire leasehold estate. Appellants sold out, got out and stayed out.

It is important to remember that this transaction was initiated by one Mr. Churchill Cook, the representative of Pacific, that he was looking for necessary space for that utility (R. 57).

Appellants were operating a cleaning establishment in the premises, had recently spent a substantial sum in improving the same for their use, and had purchased a quantity of expensive equipment, part of which they had not yet installed. They anticipated occupying the entire premises during the full balance of their term (R. 61).

The transaction which was consummated in the contract (Ex. 2-B), was initiated, according to the testimony of Mr. Cook, as follows:

> "I walked in and introduced myself to him (Mr. Voloudakis) and asked him whether or not he would consider selling out and getting out." (R. 58)

This corroborated Appellants' statement on direct examination, as follows:

> "Q. Now what were the circumstances surrounding your going out of possession, your vacating possession?
>
> A. Well, the Telephone Company wanted to—they wanted to occupy the place—wanted to—wanted me to get out of there." (R. 47)

Appellants further testify that after the transaction was consummated, they vacated the premises completely and surrendered them to Pacific. That since that time they have had no dealings whatsoever with Sweeny, nor with Pacific, except to receive the monthly check. As Mr. Voloudakis stated at the close of the deal:

> "I just put my coat on, cleaned up the place, and that's the last I've seen of it." (R. 48)

Pacific immediately took possession of the premises and spent a very substantial amount of money completely remodelling them to accommodate its accounting offices (R. 59). Indeed, the remodelling was so extensive that the property was suitable for no other occupancy except by Pacific (R. 59).

Exhibit 2-B seems to have been prepared by the agents of the owner, Sweeny, and the two letters, Exhibits N and O, were prepared by Pacific's agent, Mr.

Churchill Cook. Appellants were not in any way directly or indirectly responsible for the use of verbiage in any of these documents (R. 59, 60).

PENALTIES

Penalties assessed by Commissioner. A review of the pleadings and exhibits indicates that the Commissioner has assessed both a penalty for substantial understatement of estimated tax and in addition a penalty for failure to file a declaration of estimated tax. In other words, the Commissioner has assessed penalties under Section 294 (d) (1) of the Internal Revenue Code and penalties under Section 294 (d) (2) of the same Code. This is erroneous. The assessment of the six per cent penalty for substantial underestimation of estimated tax is improper for the reason that the tax was not underestimated. Indeed, it was not "estimated" at all. For holdings directly in agreement with Petitioners' argument, see *United States v. Risley,* 120 F. Supp. 530 at page 538 (DCND Ga. 1954); *Owen v. United States,* 134 F. Supp. 31 (DC Neb. 1955); and *Powell v. Granquist,* 146 F. Supp. 308 (DC Ore. 1956).

It seems particularly improper to make the penalty assessments above mentioned in this case for "substantial understatement of estimated tax" because it does not represent an understatement of the estimated tax at all, but rather an error made in good faith as to the basis upon which the tax should be estimated. The exact amount of the income and a precise computation of the tax were reported.

CONCLUSION

The three requisites to capital gains treatment exist in the instant case. Real property used in trade or business is an asset subject to capital gains treatment within the expressed terms of Section 117 (j) of the Internal Revenue Code of 1939. The courts have repeatedly held that a leasehold estate is such property. No contrary contention is made here.

It is stipulated that the Petitioners obtained the leasehold in question in 1946 and remained in possession for approximately a year. Thus the six months holding period required by the 1939 Code was complied with.

The transaction in 1947 (Ex. 2-B) constituted a sale or assignment of Appellants' leasehold interest to Pacific for the following reasons: (1) Appellants sold and relinquished to Pacific every shred of interest or claim they had in or to the property, their entire leasehold estate; (2) Pacinc acquired and retained for the full balance of the original lease period all of the rights of Appellants in the leased property; (3) All of Appellants' obligations under the original lease as lessee were abrogated by the execution of the new lease between the owner and Pacific covering exactly the same property and for precisely the same period; and (4) Appellants retained no reversionary rights or interests in said property whatsoever.

Thus the payments to Petitioners from Pacific were correctly reported as long-term capital gain and the Petitioners owe no additional tax on said payments.

The Commissioner was also incorrect in assessing penalties for all of the tax years in question under both Section 294 (d) (1) and Section 294 (d) (2) of the Internal Revenue Code.

Respectfully submitted,

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